

**HOW** **Alabama** **TAXES** **COMPARE** **2021**

*How Alabama Taxes Compare, 2021*

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**Public Affairs  
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## **How Alabama Taxes Compare, 2021 Edition**

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## Executive Summary

Each year PARCA analyzes data gathered by the U.S. Census Bureau in the Bureau's survey of state and local governments across the country. The report makes it possible to compare the revenue and expenditures of state and local governments across the 50 states.

In this analysis, state and local revenues are considered together, because states vary significantly in how they divide up the responsibilities between state and local governments for financing the operation of services like schools, highways, police, public health, prisons, arts and culture, and recreation.

### Key Findings

- Alabama has the lowest per capita property tax collections in the nation.
- Alabama has among the highest sales tax rates in the U.S.
- Alabama's income tax is essentially flat, with the top rate of 5% applied to an individual's taxable income over \$3,000.

Consequently, Alabama had the nation's second-lowest state and local tax collections per capita in 2019.

However, when lawmakers return to Montgomery in January for an election-year session, they will begin building budgets in a time of surplus, driven by a flood of federal stimulus that helped state and local tax collections rebound sharply in the wake of the pandemic. Unemployment is low and economic growth is high in Alabama. Federal relief and new investments flowing through state agencies will also create an unusual sense of abundance.

There will likely be calls to revisit Alabama's tax structure and tax rates. Any changes made to the tax system should be aimed creating sound tax policy – policies that are:

- Equitable—fairly apportioned among taxpayers, not falling disproportionately on lower-income residents;
- Effective—producing adequate and stable revenue, a tax climate competitive with neighboring states; and
- Efficient—easy to pay, collect, and allocate.

This report explores Alabama's tax system in more depth and context.

## Introduction

Alabama had the nation's second-lowest state and local tax collections per capita in 2019, according to the PARCA's analysis of the U.S. Census Bureau's latest available data. Only Tennessee had lower state and local tax revenue per resident than Alabama.<sup>1</sup>

This means governments in Alabama have less money than governments in other states to provide a competitive level of service. That's been the case since at least the early 1990s, when PARCA began making this comparison.

### Property Taxes

Alabama has the lowest per capita property tax collections in the nation.

Low property taxes benefit homeowners and owners of agricultural and timberland but present a challenge to local governments and schools needing to pay for adequate services. Across the country, property taxes provide a greater share of revenue and tend to provide a more stable source of revenue. In Alabama, state and local governments are forced to rely on more volatile alternatives. Our aversion to property taxes, protected by the Alabama Constitution, leads to imbalance and inadequacy.

### Sales Taxes

Alabama has among the highest sales tax rates in the U.S.,<sup>2</sup> partly as a result of constitutional roadblocks to property taxes.

Alabama is one of only three states that applies the full rate of state and local sales taxes to groceries without an offset.<sup>3</sup> Because those with lower incomes spend a

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<sup>1</sup> Tax revenues do not include lottery revenues. If Tennessee's lottery proceeds were considered it would narrow but not eliminate Alabama's advantage over Tennessee.

<sup>2</sup> Janelle Cammenga, "State and Local Sales Tax Rates, 2021," *Tax Foundation* (blog), January 6, 2021, <https://taxfoundation.org/2021-sales-taxes/>.

<sup>3</sup> "States That Still Impose Sales Taxes on Groceries Should Consider Reducing or Eliminating Them," Center on Budget and Policy Priorities, accessed November 29, 2021, <https://www.cbpp.org/research/state-budget-and-tax/states-that-still-impose-sales-taxes-on-groceries-should-consider>.



greater share of income on necessities covered by the sales tax, state and local taxes take a larger share of their income.

## **Income Taxes**

Alabama's income tax is essentially flat, with the top rate of 5% applied to an individual's taxable income over \$3,000.

Alabama requires families in poverty to pay income taxes. No other state sets a lower threshold for paying income taxes than Alabama. That threshold hasn't been adjusted since 2006.

In most states, the income tax is used to provide some balance for the regressive effects of other taxes, providing credits to low-income households to offset sales taxes, for instance. Not in Alabama.

On the other hand, Alabama will soon be the only state that allows taxpayers to completely deduct federal income taxes when calculating state taxes, a tax break that disproportionately benefits upper-income earners.<sup>4</sup>

Federal deductibility also means that when federal taxes go up, state taxes go down and vice versa. When federal tax deductions and credits are raised, the state automatically takes back some of the benefit the federal tax change is intended to provide.

When lawmakers return to Montgomery in January for an election-year session, they will begin building budgets in a time of surplus, driven by a flood of federal stimulus that helped state and local tax collections rebound sharply in the wake of the pandemic. Unemployment is low and economic growth is high in Alabama. Federal relief and new investments flowing through state agencies will also create an unusual sense of abundance.

Flush times could allow Alabama to address years of chronic underinvestment compared to other states. Unacceptable conditions, like understaffed and crumbling prisons and an underperforming education system, have been allowed to fester. The state has not taken advantage of federal support for expanding Medicaid to provide health insurance to adults in poverty. Resistance is based at least partly on the

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<sup>4</sup> Jared Walczak, "Federal Deductibility Is Distorting Tax Liability in Six States," *Tax Foundation* (blog), November 1, 2021, <https://taxfoundation.org/federal-deductibility/>.

assertion that Alabama could not afford it.

Effective tax policy is generally considered to be:

- Equitable—fairly apportioned among taxpayers, not falling disproportionately on lower-income residents;
- Effective—producing adequate and stable revenue, a tax climate competitive with neighboring states; and
- Efficient—easy to pay, collect, and allocate.

Alabama tax policy struggles on all three points. Any changes made to the tax system should be aimed at addressing these shortcomings.

## Alabama Taxes Compared: An Overview

Each year PARCA analyzes data gathered by the U.S. Census Bureau in the Bureau's survey of state and local governments across the country. The report makes it possible to compare the revenue and expenditures of state and local governments across the 50 states.<sup>5</sup>

In PARCA's analysis of the data, state and local revenues are considered together, because states vary significantly in how they divide up the responsibilities between state and local governments for financing the operation of services like schools, highways, police, public health, prisons, arts and culture, and recreation.

In the discussion that follows, Alabama's per capita collections are compared with other Southeastern states. In general, Alabama's approach to government and taxation is more similar to other Southeastern states than to the governments in other regions.

Since the early 1990s, Alabama has maintained the lowest tax collections in the U.S. But beginning in 2018, tax cuts in Tennessee and economic growth in Alabama caused Tennessee to dip below Alabama's per capita collections.<sup>6</sup>

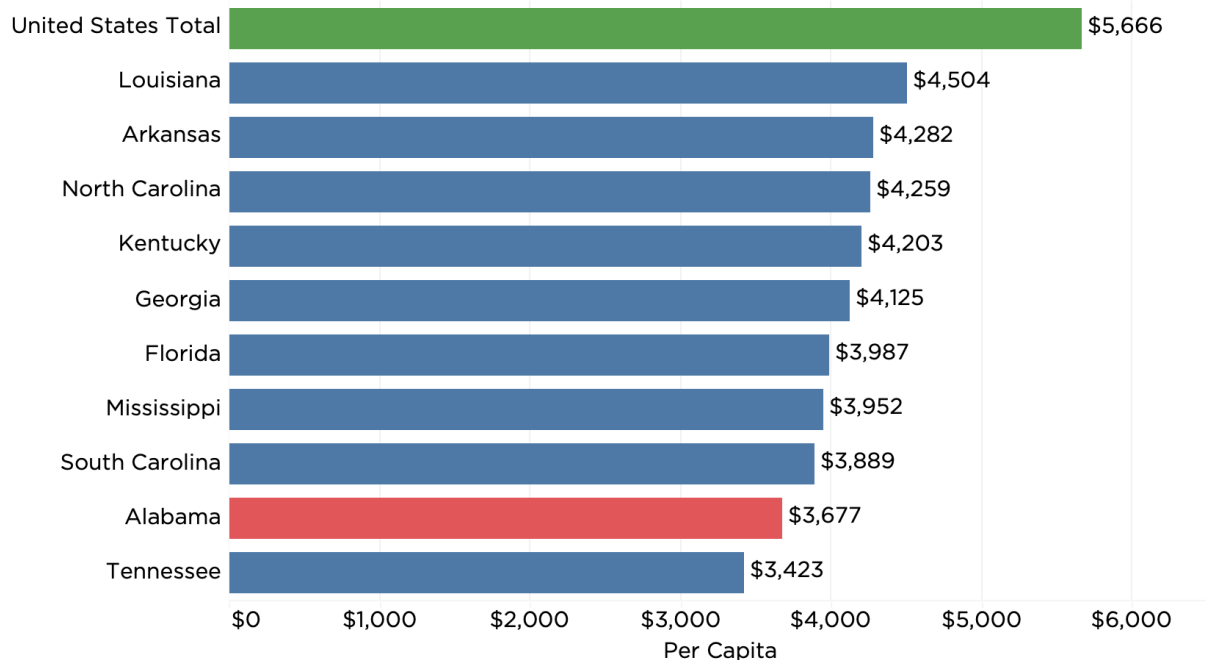
In 2019, Alabama collected \$3,677 in per capita revenue.

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<sup>5</sup> US Census Bureau, "2019 State & Local Government Finance Historical Datasets and Tables," The United States Census Bureau, accessed October 28, 2021, <https://www.census.gov/data/datasets/2019/econ/local/public-use-datasets.html>.

<sup>6</sup> This comparison considers tax revenues but does not consider lottery proceeds or other revenue generated through charges or fees.

Figure 1. Total State and Local Taxes Collected Per Capita, 2019, Southeastern States and U.S. Average



State and local tax collections are based on two fundamental factors: tax rates and the value of the tax base to which the rate is applied. Alabama combines low tax rates with a less valuable base of economic activity, yielding less in taxes per capita and less revenue for state and local government to provide services.

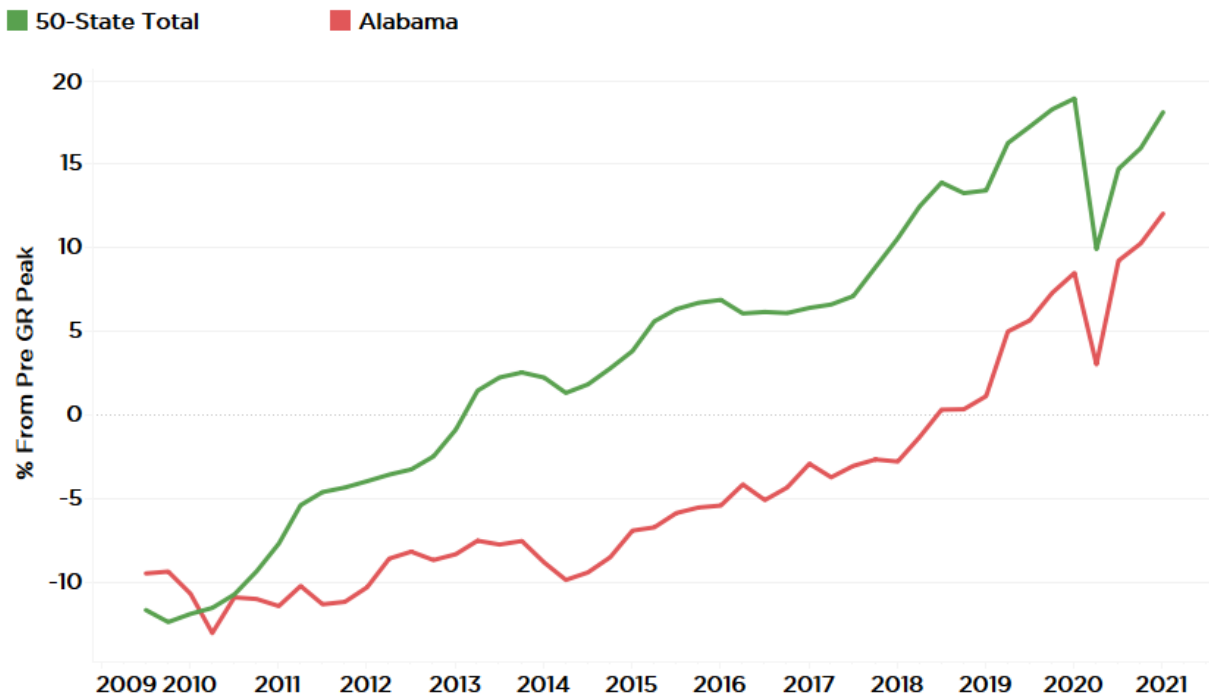
Alabama tax revenues tend to fall more sharply than other states when the economy contracts and Alabama tends to be slower to recover.

Figure 2 charts Alabama's recovery from the Great Recession compared to other states. By the first quarter of 2015, most states' tax revenues had recovered to their pre-recession peaks. Alabama didn't reach its pre-recession peak until the third quarter of 2018.<sup>7</sup>

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<sup>7</sup> "Fiscal 50: State Trends and Analysis," accessed December 3, 2021, <http://pew.org/1Etrxxk>.

Figure 2. Percentage Change in State Tax Revenue from Pre-Great Recession Peak, adjusted for inflation. Source: Pew Charitable Trusts.



However, since 2018, Alabama's economic growth has been strong. Between 2018 and 2020, per capita personal income in [Alabama grew faster than it did in Tennessee](#).

By late 2019, Alabama was experiencing its lowest unemployment ever. On top of that, the state's labor force participation rate had improved, bringing more workers into the workforce. Thus, the growth in tax collections has been based on a tax base that has grown in value.

Alabama has also benefited from the federal Tax Cuts and Jobs Act of 2017. Since Alabama allows both individual and corporate taxpayers to deduct federal income tax paid when calculating state taxes, a tax cut at the federal level translates into an increase in taxes at the state level.

Between the 2018 and 2019 period covered by the latest Census report, Alabama income tax revenue increased by almost \$281 million, or 7%. Alabama state and local general sales tax revenue increased \$250 million or 5%. Despite that strong growth, tax collections grew faster in Georgia, Kentucky, South Carolina, Mississippi, and North Carolina.

On the other hand, recent adjustments to Tennessee's tax rates decreased that state's per capita collections. The Volunteer State is phasing out what remains of its small income tax, a tax applied only to interest and dividend income. It has also reduced its state sales tax rate on groceries from 5% to 4%.

Meanwhile, property taxes collections, the primary tax for Tennessee local governments, have been held down during the period in question. Despite soaring property tax values, a dispute over Nashville's property taxes has held collections flat in that state's largest county. The conflict has the booming city in an unexpectedly troubled financial position.

Low taxes bring both benefits and trade-offs.

Low taxes leave additional money in the hands of state residents and potentially attract businesses looking for a lower cost of doing business.

But low state and local taxes can make it difficult for governments to provide a competitive level of infrastructure, education, public safety, and public health to taxpayers and those businesses it wishes to attract.

And just because Alabama has low state and local tax collections overall, that doesn't mean that everyone's taxes are low.

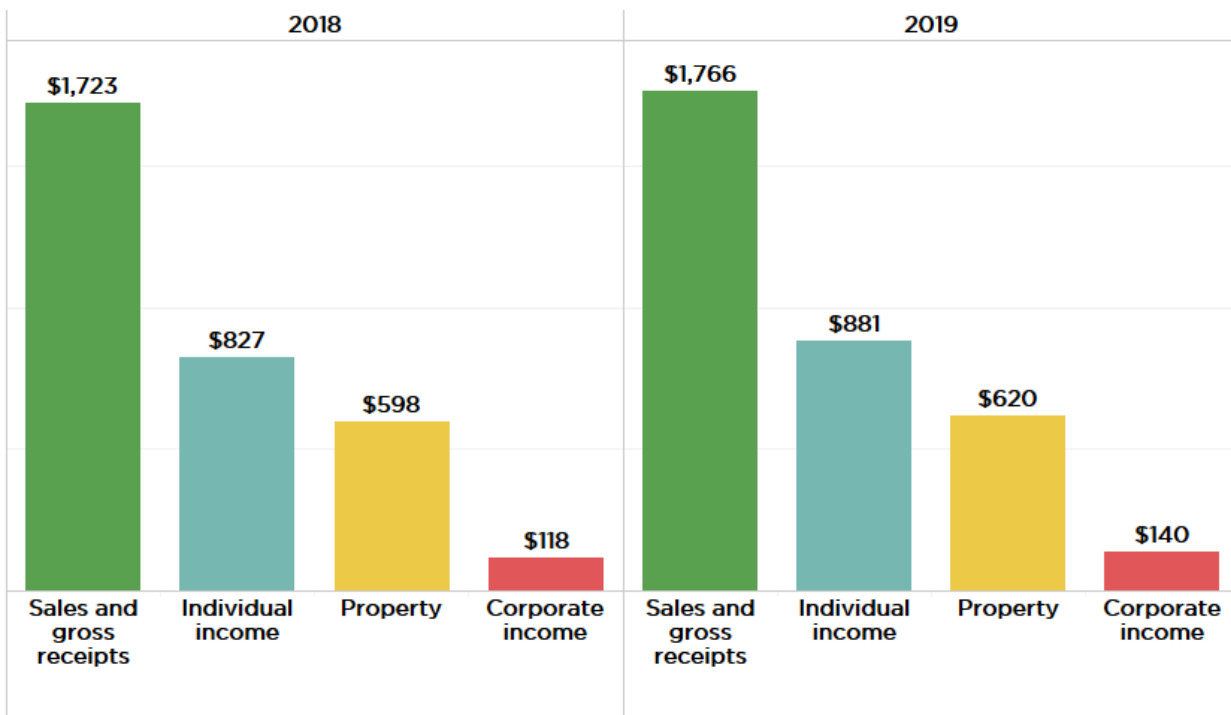
Table 1. Alabama Rank in Per Capita Tax Collections, 2019

State and Local Tax Sources	Alabama's Rank Among U.S. States
All Taxes	49
Property	50
Individual income	36
Corporate income	30
Sales and gross receipts	30
General sales	32
Selective sales	18
Alcoholic beverage	3
Public utilities	5
Motor fuel	32
Tobacco products	37
Other selective sales	31
Motor vehicle licenses	43
Other taxes	30

## How Alabama Taxes Compare

In 2019, Alabama state and local governments collected \$3,677 per resident through sales, property, income, and an array of other taxes. That's up from \$3,527 in 2018, a gain of \$150. Alabama's per capita tax collections increased in all major categories, reflecting a growing economy.

Figure 3. Change in Alabama Per Capita Tax Collections, 2018–2019, Source: U.S. Census Bureau.



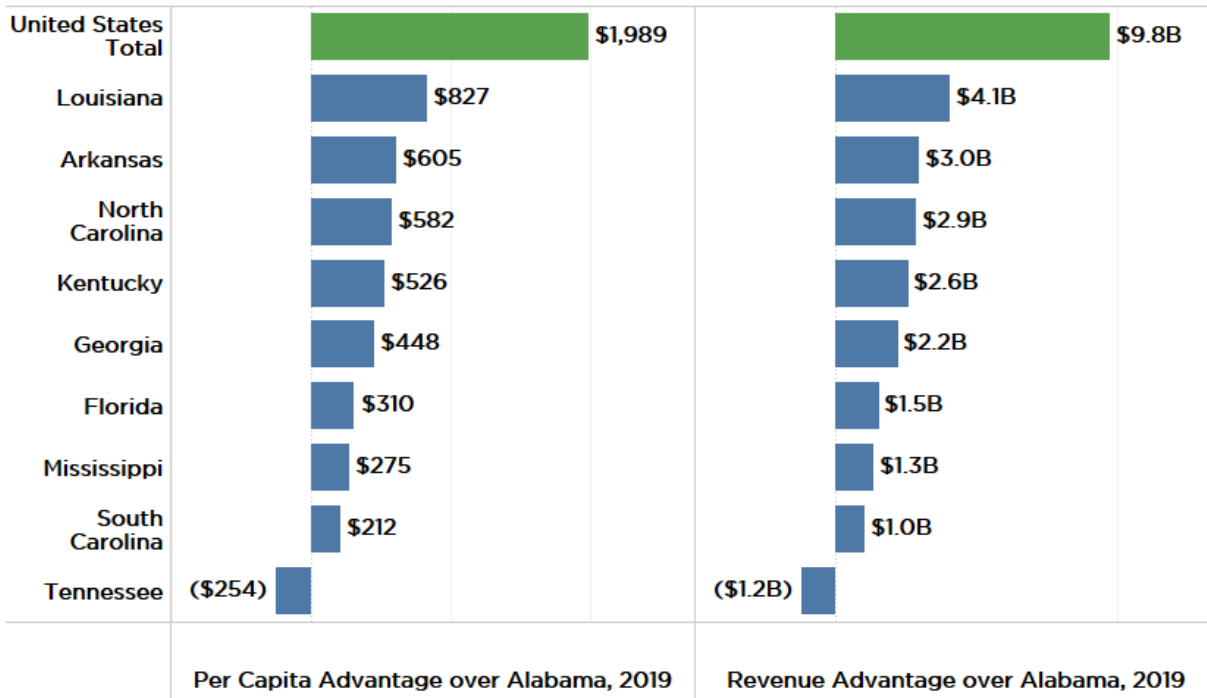
Still, Alabama ranked second to last in the U.S. and among Southeastern states in state and local tax collections per resident. Among Southeastern states, the average per capita rate was \$4,030, \$353 per resident higher than Alabama. The median value for U.S. states was \$5,423 per capita, \$1,746 more per resident than Alabama. The data for 2019 is the most recent year available.

Alabama's gain in per capita tax collections between 2018 and 2019 ranked sixth out of the 10 Southeastern states, trailing Kentucky, Georgia, North Carolina, and South Carolina.

Figure 4 presents two sets of comparisons: 1) the per capita advantage enjoyed by other Southeastern states over Alabama and 2) the revenue advantage that level of taxation provides those other states. The revenue advantage is the per capita tax

advantage multiplied by Alabama's population. In other words, if Alabama's tax system produced the same level of revenue per capita as the comparison state, Alabama would have that much more to spend on providing services to its residents.

Figure 4. Southeastern States' Per Capita Tax Collection and Revenue Advantage Over Alabama



Louisiana collects nearly \$827 more per resident than Alabama, an advantage that derives in part from its gas and oil production. With the same tax base and tax rates as Louisiana, Alabama would bring in an additional \$4.1 billion in taxes. If Alabama collected taxes at the same per capita rate as South Carolina, Alabama would have an additional almost \$1 billion to spend. Mississippi, a state with less wealth and economic activity, nevertheless collects \$275 more per capita than Alabama. If Alabama collected taxes at Mississippi's rate, state and local governments would have an additional \$1.3 billion to fund education, health care, highways, public safety, and the broad spectrum of state and local services provided.

Conversely, Alabama's enjoyed a revenue advantage over Tennessee, which enabled Alabama state and local governments to spend more than Tennessee on education, highways, and health on a per capita basis. It should be noted that Tennessee has at



least one source of revenue Alabama does not: a lottery.<sup>8</sup> In 2019, Tennessee's lottery provided that state with \$442 million to spend on education-related programs. That includes college scholarships for Tennessee students.

*If Alabama collected taxes at Mississippi's rate, the state would have an additional \$1.3 billion to fund education, health care, highways, public safety...*

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<sup>8</sup> All Southeastern states provide a lottery. [Alabama doesn't.] These revenues are not included in the analysis. State taxes on other forms of gambling, like casino operations, are included in the comparison.

## Alabama's Low Per Capita Tax Revenues

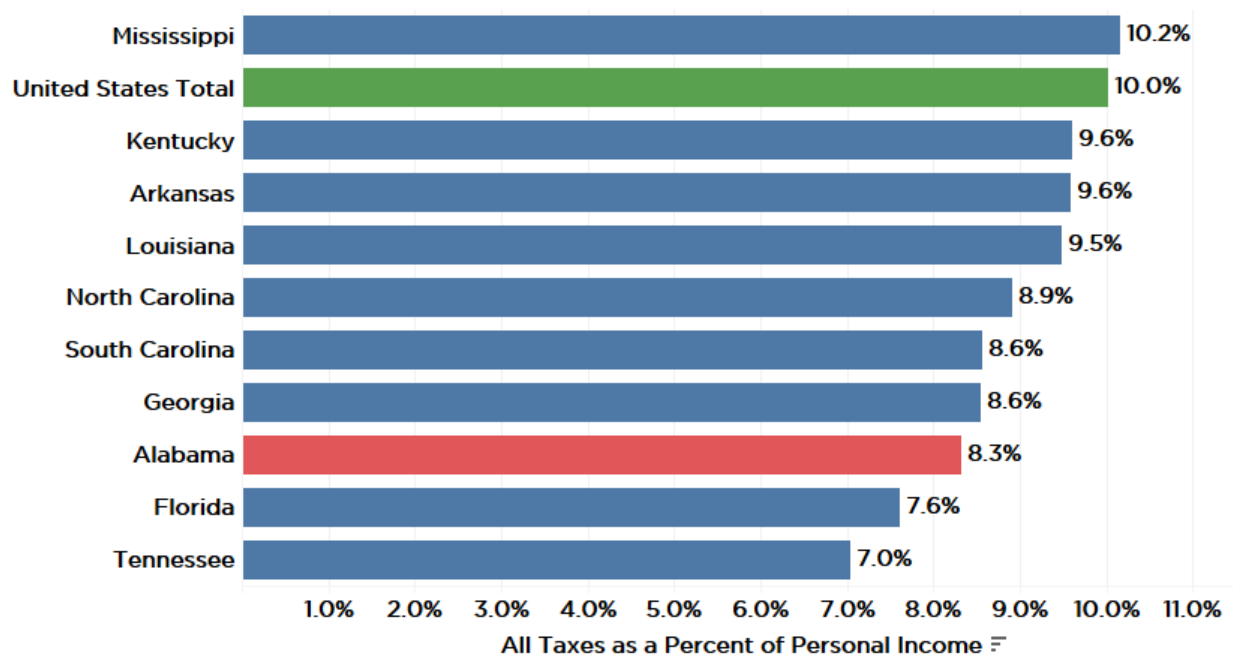
Our low tax revenue per capita results from two primary factors: lower tax rates than most other states and a smaller wealth base than most other states.

*Alabama has tax rates that are lower than most other states and a base of wealth that is smaller than most.*

### Taxes as a Percentage of Personal Income

Comparing total personal income to the total of state and local taxes collected, Alabama ranks No. 45 in the country, with state and local tax collections amounting to 8.3% of state residents' total personal income. Only five states—New Hampshire, Alaska, South Dakota, Florida, and Tennessee—collect less in taxes as a percentage of personal income.

Figure 5. Taxes as a Percent of Personal Income, 2019. Source: Census Bureau and U.S. Bureau of Economic Analysis.<sup>9</sup>



<sup>9</sup> U.S. Bureau of Economic Analysis, "SAINC1 Personal Income Summary" Retrieved Oct. 29, 2021, [https://apps.bea.gov/iTable/iTable.cfm?reqid=70&step=30&isuri=1&major\\_area=0&area=xx&year=2019&tableid=21&category=421&area\\_type=0&year\\_end=-1&classification=non-industry&state=0&statistic=1&yearbegin=-1&unit\\_of\\_measure=levels](https://apps.bea.gov/iTable/iTable.cfm?reqid=70&step=30&isuri=1&major_area=0&area=xx&year=2019&tableid=21&category=421&area_type=0&year_end=-1&classification=non-industry&state=0&statistic=1&yearbegin=-1&unit_of_measure=levels)

Each of those states has a higher personal income per capita than Alabama, so despite collecting less as a percentage of total personal income, all those states, except Tennessee, raise more revenue per capita than Alabama. They can produce high tax revenues with less tax effort.

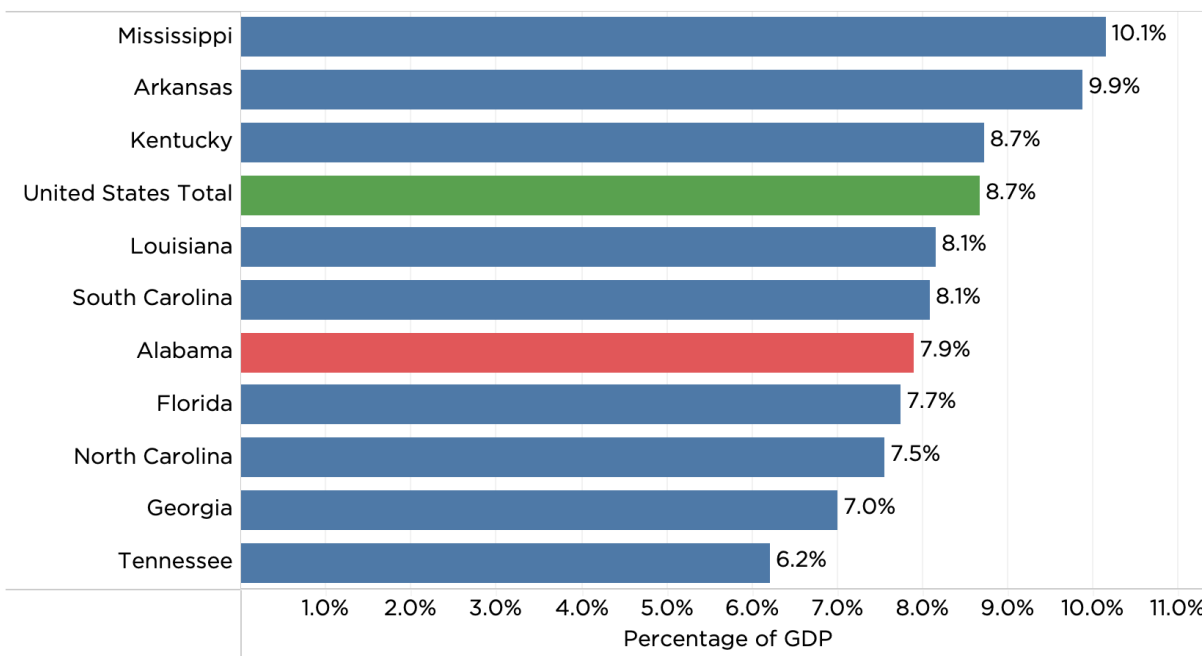
Mississippi's total personal income is lower than Alabama's, but its state and local government tax collections equaled 10% of Mississippi's total personal income for 2019. Because of that greater tax effort, Mississippi state and local governments have more to spend on a per capita basis than those in Alabama.

## Tax Burden as a Percent of GDP

Another way of measuring the tax burden is to calculate tax collections as a percentage of each state's gross domestic product (GDP), a measure of economic output.

Alabama tax collections amount to 7.9% of its GDP. The U.S. average for state and local taxes as a percentage of GDP for 2019 was 8.6%. Alabama ranks No. 39 in taxes as a percentage of GDP.

Figure 6. Taxes as a Percentage of GDP, 2019. Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis.<sup>10</sup>



<sup>10</sup> "<https://Apps.Bea.Gov/Itable/ITable.Cfm?ReqID=70&step=1>," accessed December 6, 2021, <https://apps.bea.gov/itable/iTable.cfm?ReqID=70&step=1>.

As with the personal income measure, states like Georgia, North Carolina, and Florida have a higher economic output level than Alabama on a per capita basis. Thus, those states can tax at a lower percentage of economic activity and still yield higher tax revenues.

## What We Choose to Tax

While a state's tax base and tax rates are primary drivers of the total revenue collected, a state's tax system is also affected by the mix of taxes it applies.

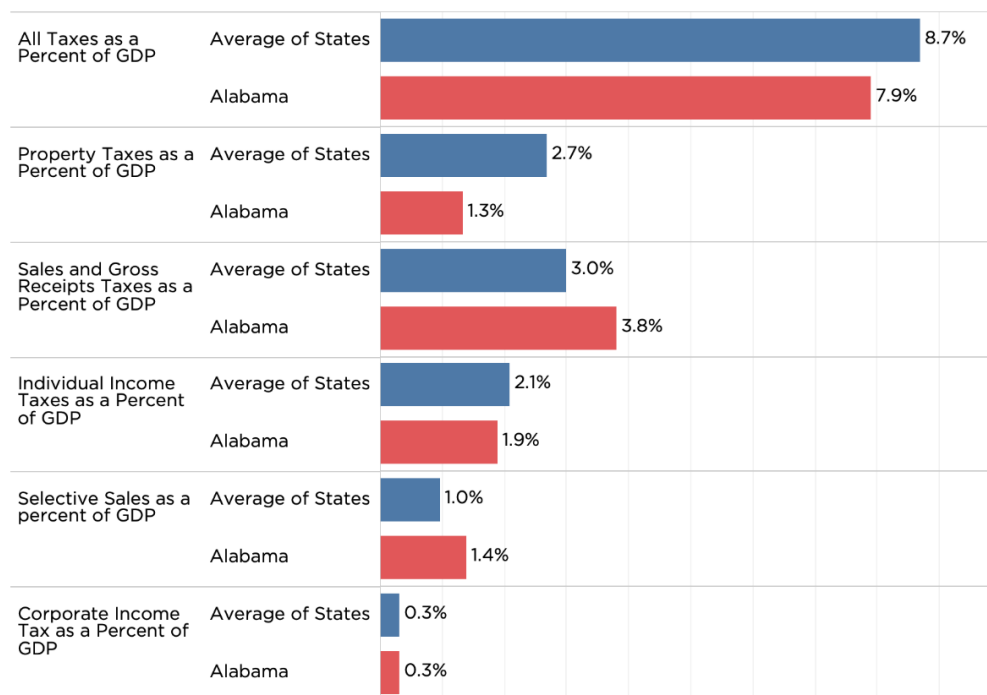
Every state has a unique blend of taxes. Most states depend on some combination of the three principal tax sources: income, property value, and sales transactions (what we earn, own, and buy).

A tax system that is balanced among these three sources promotes fairness and stability.

### Alabama's Tax System Is not Balanced

Figure 7 compares Alabama's tax mix to that of the average U.S. state. The relative share of each tax is expressed as a percentage of GDP. Alabama's overall tax burden is lighter, a smaller share of GDP, than the average U.S. state.

Figure 7. Types of Taxes and Gross Domestic Product, Alabama and U.S. Compared, 2019. Source: U.S. Census Bureau and U.S. Bureau of Economic Analysis.



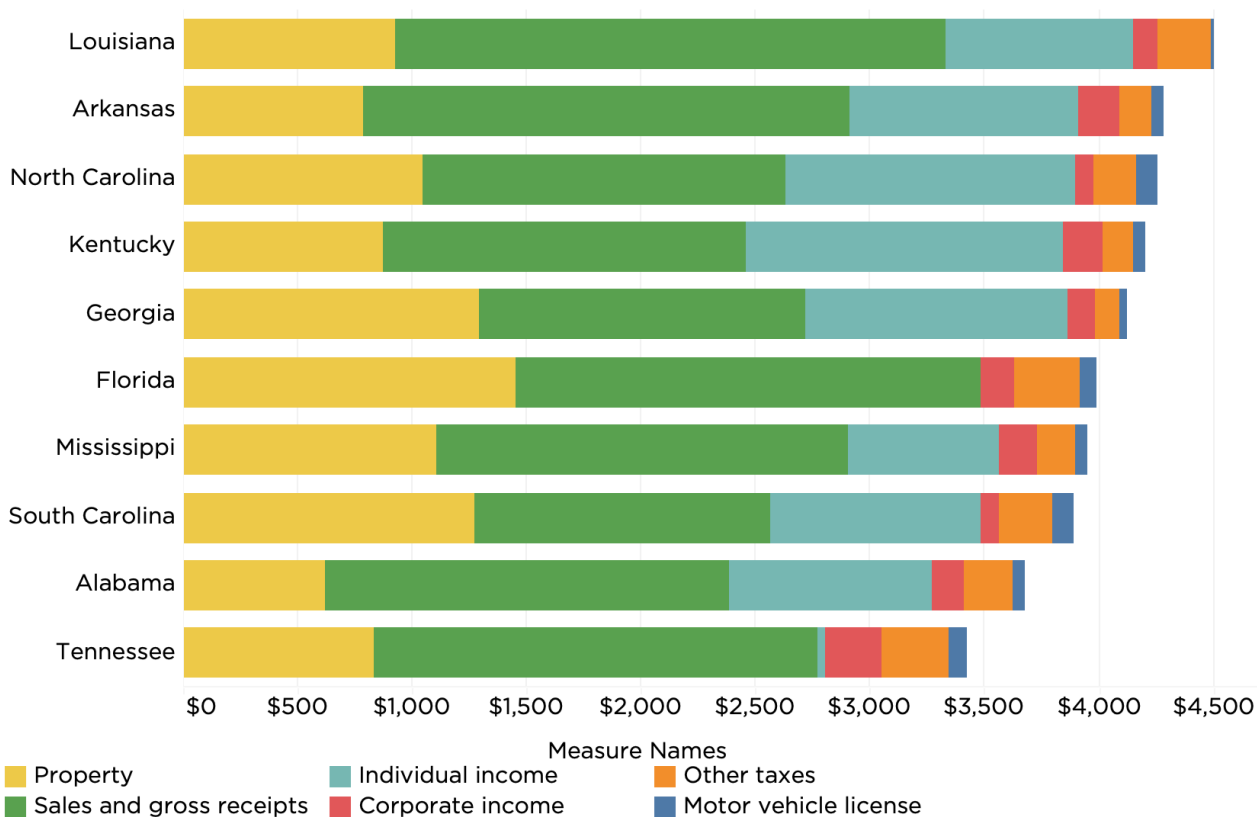
State and local property taxes are particularly low. As a percentage of GDP, Alabama's property taxes equal only 1.3% of GDP, compared to 2.7% in the average state. Alabama's per capita property tax collections could be doubled and still be below the U.S. average.

On the other hand, Alabama's sales and gross receipts tax is a higher share of GDP than the average state, indicating that Alabama depends more heavily on sales taxes to produce tax revenue than most states. That includes selective sales taxes, which, as represented by the green bars in the chart below, are also disproportionately relied on by Alabama governments.

Alabama's individual income tax collections per capita are also lower than the national average, while corporate income and other taxes are roughly equivalent to those in other states in terms of percentage of GDP.

Figure 8 compares Alabama's state and local tax mix with other Southeastern states, expressed on a per capita basis. The chart shows the different blend of taxes each state uses to produce total state and local tax revenues.

Figure 8. Mix of Taxes Per Capita in the Southeast, 2019, by tax source. Source: U.S. Census Bureau, PARCA Calculations.



The portion of the bar representing Alabama's property taxes, colored yellow, is shorter than the yellow section in any other state, reflecting lower per capita tax collections overall.

Alabama never catches up to other states but does pass one: Tennessee. Alabama's individual income tax provides enough to offset Tennessee's higher per capita property, sales, and corporate income tax collections.

Meanwhile, other states exhibit their own unique mixes. Florida does not have an income tax but makes up for it with high property and sales tax collections per capita.

*Florida compensates for no income taxes with higher per capita property and sales tax collections.*

## **The Tax Mix: A Balancing Act**

Although Alabama collects less in state and local taxes per resident than any other state, that does not guarantee low taxes for all. Because of the imbalance in the tax structure, taxes fall more heavily on some groups than others.

A sound tax structure avoids placing too heavy a burden on any particular group. Most states take measures to protect households with low incomes from taxation to encourage economic advancement.

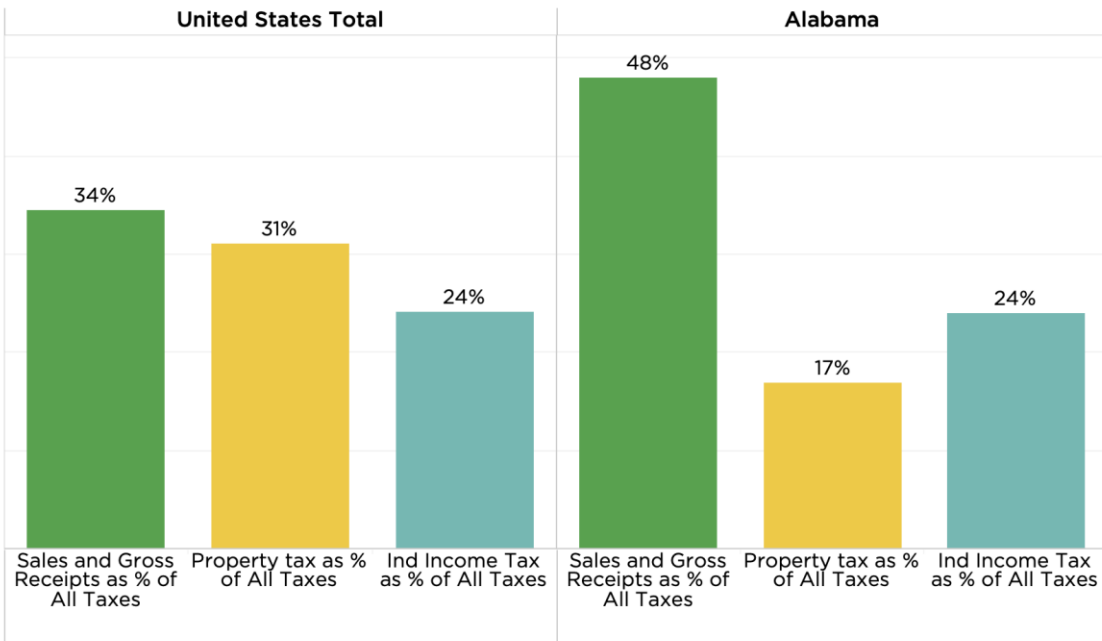
As lawmakers consider adjustments to tax revenue, questions of balance and fairness should be considered.

### **Property Taxes**

Alabama's state and local property tax collections are lower than any other state, creating an imbalance in the state's tax system.

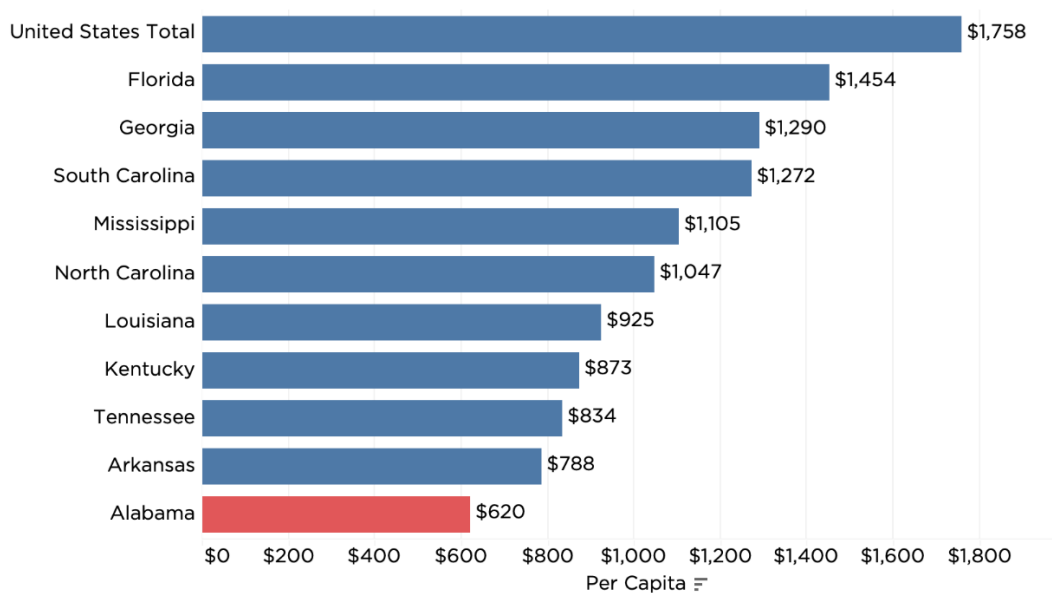
When all state and local revenue across the U.S. is considered, property taxes generate 31% of revenue, second to sales and gross receipts, and ahead of income taxes. In Alabama, property taxes account for only 17% of state and local revenue and rank third behind income and sales taxes.

Figure 9. Principal tax sources as a percentage of state and local tax revenues, all states vs. Alabama, 2019. Source: U.S. Census Bureau, PARCA Calculations.



Alabama's property taxes are low not only in comparison to all states but also in comparison to peer states in the Southeast.

Figure 10. Per Capita State and Local Property Tax Collections, 2019. Source: U.S. Census Bureau, PARCA Calculations.



The mechanisms for raising property taxes embedded in the Alabama Constitution make raising rates or adequate revenue through the property tax difficult. Local

property tax increases must be recommended by a local government body, approved for the ballot by the state legislative delegation, and voted on by the affected voters.

Even if voters approve a rate change, Alabama's constitutional property tax classifications and caps hold down the amount of revenue generated. That is particularly true in communities with limited commercial property, where the land is mostly in homes or in agriculture.

Alabama's low property taxes primarily benefit those who own homes, farms, and timberland. Those properties are taxed on just 10% of their value. Their property tax bills are further reduced through homestead exemptions and valuations based on the current use of the property rather than current market prices for the land and buildings.

Meanwhile, taxes on commercial and industrial property are double that of residences or farms because that property is taxed on 20% of its value. Property owned by utilities is taxed on 30% of its value, three times the residential or agricultural property rate.

Under the current property classification system, an increase in property tax rates would be borne more heavily by businesses and utilities. Increases would also likely be passed along to consumers and to renters, since apartments are considered commercial property. And higher tax bills for utilities would likely be passed along to ratepayers.

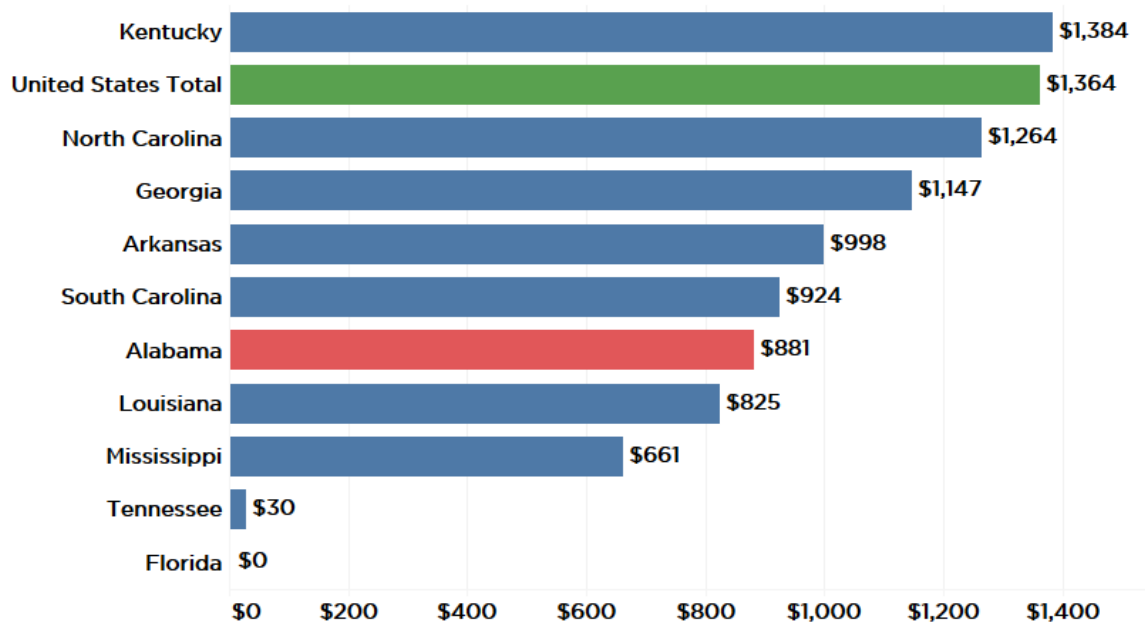
## **Income Taxes**

In 2019, Alabama's income tax revenue per capita ranked 36th out of the 43 states that collect income taxes.

*In 2019, Alabama's income tax revenue per capita ranked 36th out of the 43 states that collect income taxes.*



Figure 11. Per Capita State and Local Individual Income Tax Collections, 2019. Source: U.S. Census Bureau, *PARCA Calculations*.



In many states, the income tax is progressive, applying a higher rate to individuals with higher income levels. The income tax can serve as a balance against the regressive nature of other taxes.

However, in Alabama, several features of the tax work to interfere with the progressive nature of the tax. It sets the lowest threshold for taxing income in the U.S., requiring poverty-level families to pay income taxes. And it gives an unusual break to high-income earners: It allows a full deduction for federal income tax paid. That's a break that does nothing for low-income Alabamians but is generous to high earners. Allowing the deduction for federal income taxes results in \$650 million less in state income tax collections.<sup>11</sup>

Until this year, two other states also allowed residents to fully deduct federal taxes paid: Louisiana and Kansas.<sup>12</sup> Both states have now moved to end deductibility. Soon Alabama will stand alone.

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<sup>11</sup> REPORT ON ALABAMA TAX EXPENDITURES, Legislative Services Agency, Fiscal Division. February 2021. accessed December 8, 2021, <http://lsa.state.al.us/PDF/Fiscal/TaxExpenditure/ExpendReport2021.pdf>.

<sup>12</sup> Walczak, "Federal Deductibility Is Distorting Tax Liability in Six States."

## History

Alabama's income tax was created in the depths of the Great Depression and at the time only applied to the wealthy. Authorized by a 1933 Constitutional amendment, Alabama income tax has just three tax brackets that closely resemble the brackets set up in the 1935 enabling legislation.

- The first \$500 of income is taxed at 2%
- Income between \$500 and \$2,999: 4%
- Income above \$3,000: 5%

Those tax brackets were supposed to create a progressive income tax that rises in percentage terms as the taxpayer's ability to pay rises. But, because the brackets have undergone only minor adjustment, they are almost meaningless today.

Also unchanged are the personal exemptions of \$1,500 for single adults and \$3,000 for married couples, created by the 1935 law that implemented the tax.

That meant married couples with \$3,000 of taxable income didn't pay income taxes. In 1935, personal per capita income was only \$216.<sup>13</sup> Thus, very few married couples or individuals made enough to be subject to the tax. In 1935, only 7,000 Alabamians earned enough to owe income tax, one-quarter of 1% of the population.<sup>14</sup>

A standard deduction was added later, and it was adjusted in 2006, the last time Alabama provided any tax relief for low-income households.

The 2006 reform protected income up to \$12,600 for a family of four from income taxes.

Since then, other states have continued to adjust their exemptions and standard deductions. Alabama continues to tax income at the lowest level threshold in the United States.<sup>15</sup>

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<sup>13</sup> U.S. Bureau of Economic Analysis and Federal Reserve Bank of St. Louis, Per Capita Personal Income in Alabama [ALPCPI], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/ALPCPI>, December 6, 2021.

<sup>14</sup> Alabama Arise, "The Alabama Tax & Budget Handbook," *Alabama Arise* (blog), May 2, 2015, <https://www.alarise.org/resources/the-alabama-tax-budget-handbook/>.

<sup>15</sup> "NCCP | 50-State Policy Tracker," accessed November 19, 2021,

In Alabama, any income that a family makes above \$18,500 is taxed at the top rate of 5%. An Alabama family of four with income at the federal poverty threshold (\$25,750 in 2019) paid over \$700 in state income taxes.

In 34 states, that family would not owe income taxes. In 19 states, that family would have received a tax credit payment.

Similarly, the federal government has increasingly pursued a policy of leaving earned income in the hands of low-income households. The federal Tax Cut and Jobs Act of 2017 replaced exemptions and standard deductions with one larger standard deduction, a deduction that adjusts for inflation.

In 2022, a couple filing jointly will have \$25,900 of earnings shielded from federal income taxes through the standard deduction. In addition, the federal system adds a \$2,000 per child tax credit. And in addition to that, qualifying low-income families with children can receive money back through an Earned Income Tax Credit of up to a maximum of \$6,935.

*Taking into account exemptions and standard deductions, an Alabama family of four begins paying income taxes on anything earned over \$12,600.*

While Alabama does little to spare low-income households from the income tax burden, it provides a break that primarily benefits high-earning households. Alabama allows taxpayers to deduct the full amount they pay in federal income taxes. Due to changes this year in Iowa and Louisiana, Alabama will become the only state where federal income taxes are fully deductible.

Since upper-income taxpayers pay a greater percentage of income in federal taxes, those higher earners get a larger break on Alabama income taxes. Meanwhile, the federal government has much larger deductions and exemptions, so the lowest income workers pay little to no federal income taxes.

The deductibility of the federal income tax also creates unintended consequences. When federal taxes go down for individuals, their state taxes go up.

The income tax rate and the deductibility of federal income taxes are both embedded in the Alabama Constitution, so any change to the rate would require an

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<http://www.nccp.org/tools/policy/>

amendment to the constitution.

Louisiana did just that. In November 2021, voters there approved a Constitutional amendment that will end the deduction for federal income tax paid and lower state income rates. The top income tax rate there is currently 6%, a rate that will be gradually reduced to 4.25% if certain conditions are met.

Alabama can change the standard deduction legislatively and create a system of credits, if desired. Some states offset the effect of the sales tax on food by effectively paying back low-income families for the taxes they paid on groceries and medications. This is a method of compensating for the regressive nature of the sales tax, which takes a greater share of income from low-income households. It is a more targeted way to create balance than eliminating the sales tax on groceries for everyone.

## **Sales Tax**

Partly because of the difficulty of raising property taxes, Alabama state and local governments have developed a heavy reliance on the sales tax.

Alabama's sales tax rates are among the highest in the country. According to calculations by the Tax Foundation, Alabama has the fifth highest combined state and local tax rates in the country.<sup>16</sup>

And unlike many other states, Alabama's sales tax applies to groceries and medications. Alabama is one of three states that continues to apply sales tax fully to food purchased for home consumption without providing any offsetting relief for low- and moderate-income families.<sup>17</sup>

*Alabama state and local governments have developed a heavy reliance on the sales tax*

Because low- and moderate-income families spend a greater share of their incomes on basic necessities, a greater share of those families' incomes goes to paying state

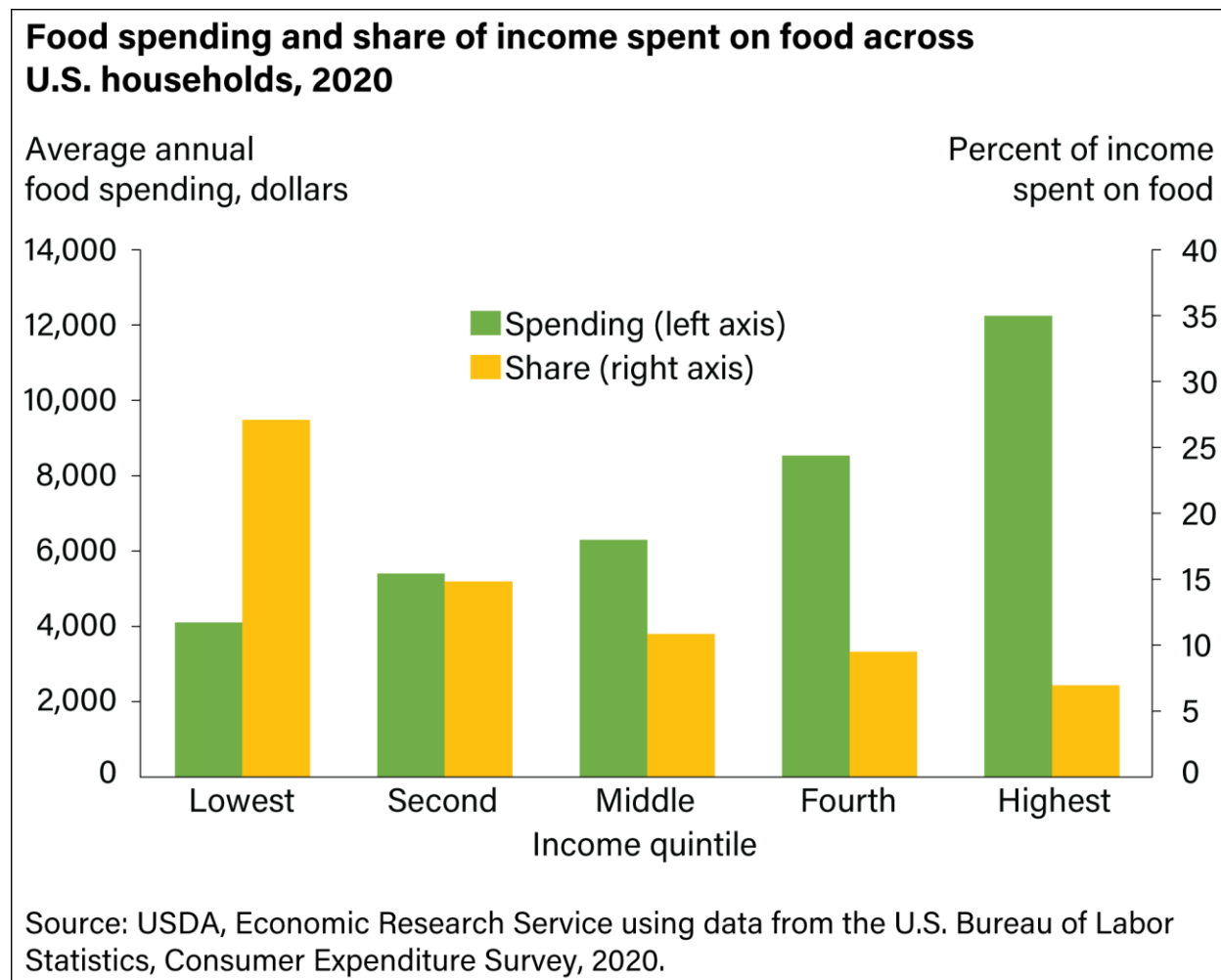
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<sup>16</sup> Janelle Cammenga, "State and Local Sales Tax Rates, Midyear 2020," *Tax Foundation* (blog), July 8, 2020, <https://taxfoundation.org/state-and-local-sales-tax-rates-2020/>.

<sup>17</sup> "States That Still Impose Sales Taxes on Groceries Should Consider Reducing or Eliminating Them," Center on Budget and Policy Priorities, Updated April 2020 <https://www.cbpp.org/research/state-budget-and-tax/states-that-still-impose-sales-taxes-on-groceries-should-consider>.

and local taxes.

Figure 12. Percentage of income spent on food, by income level, USDA estimate

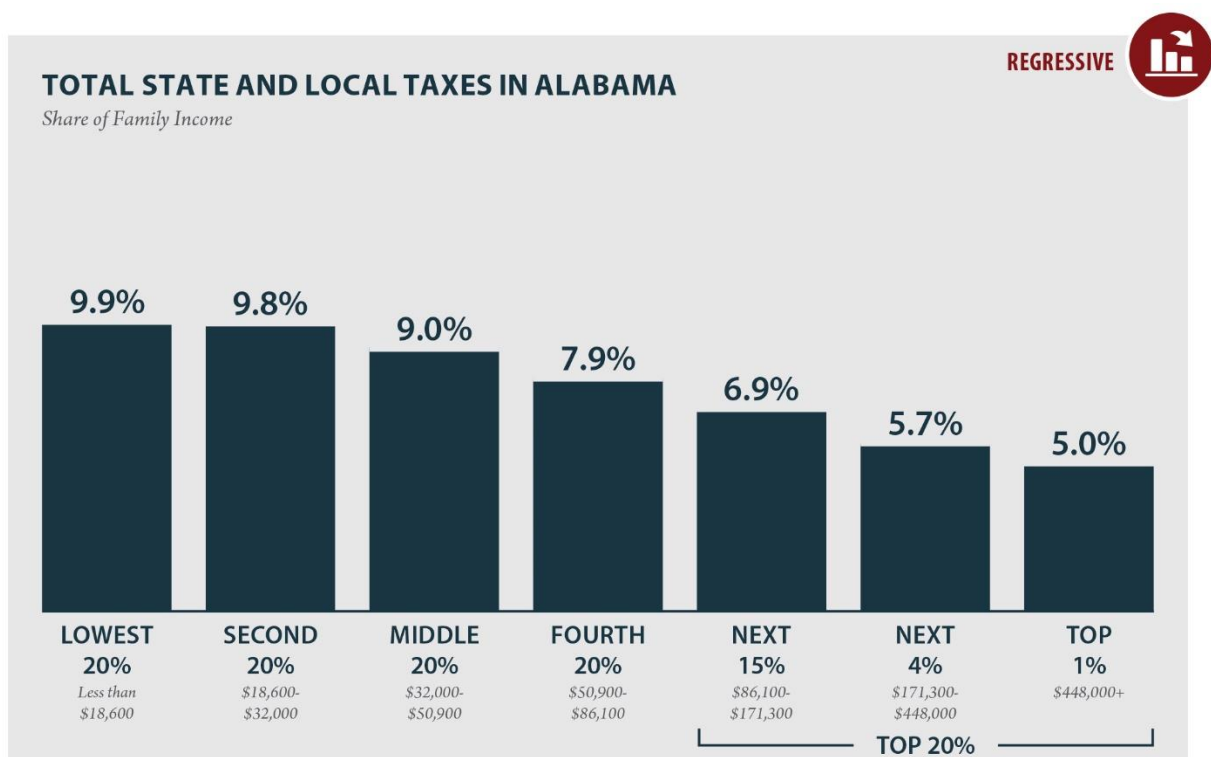


Alabama's high sales taxes contribute to the regressive nature of our tax structure. According to an analysis by the Institute on Taxation and Economic Policy, Alabama's tax system is the 18th most regressive state and local tax system in the nation.<sup>18</sup>

Under a regressive tax system, the poor pay a greater share of their income in taxes than the wealthy.

<sup>9</sup> <sup>18</sup> "Who Pays? 6th Edition," ITEP, accessed December 5, 2021, <https://itep.org/whopays/>

Figure 13. State and local taxes as a percentage of income, by income quintile. Source: Institute on Taxation and Economic Policy

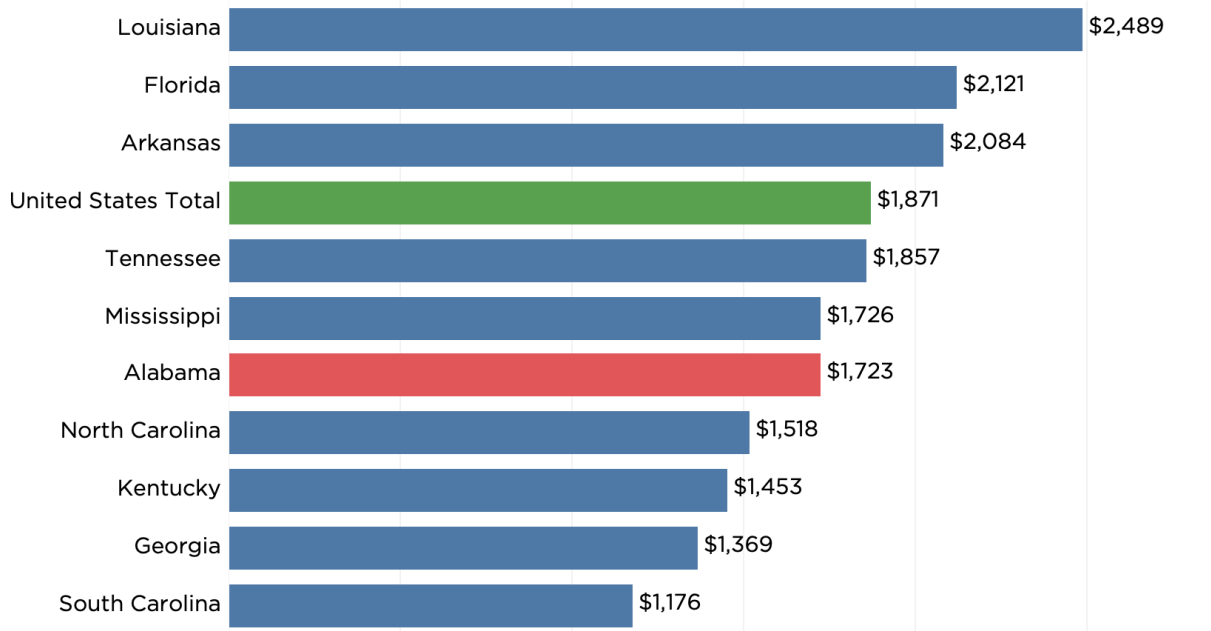


Alabama's per capita state and local sales tax collections rank 26th among the 50 states, despite high sales tax rates. Alabama's sales taxes are not as productive as other states' because of the smaller base of economic activity and because Alabama's sales tax is narrow compared to most states.

Alabama applies its tax to almost all sales of goods, but it does not apply the tax to most kinds of business, professional, computer, personal, and repair services. In recent decades, a greater share of economic activity has shifted toward the consumption of such services. According to a survey conducted by the Federation of Tax Administrators, Alabama taxes 42 out of 176 categories of services.<sup>11</sup> The median state applies the sales tax to 60 different services.

Other states also allow more forms of gambling than Alabama and apply a tax to that activity, bolstering the sales and gross receipts taxes in those states.

Figure 14. Per Capita Sales and Gross Receipts, 2018. Source: U.S. Census Bureau, PARCA Calculations.



States, including Alabama, are pursuing various options for broadening the sales tax to capture the sales activity transacted on the Internet. Those transactions have, up until recently, been generally off-limits to taxation.

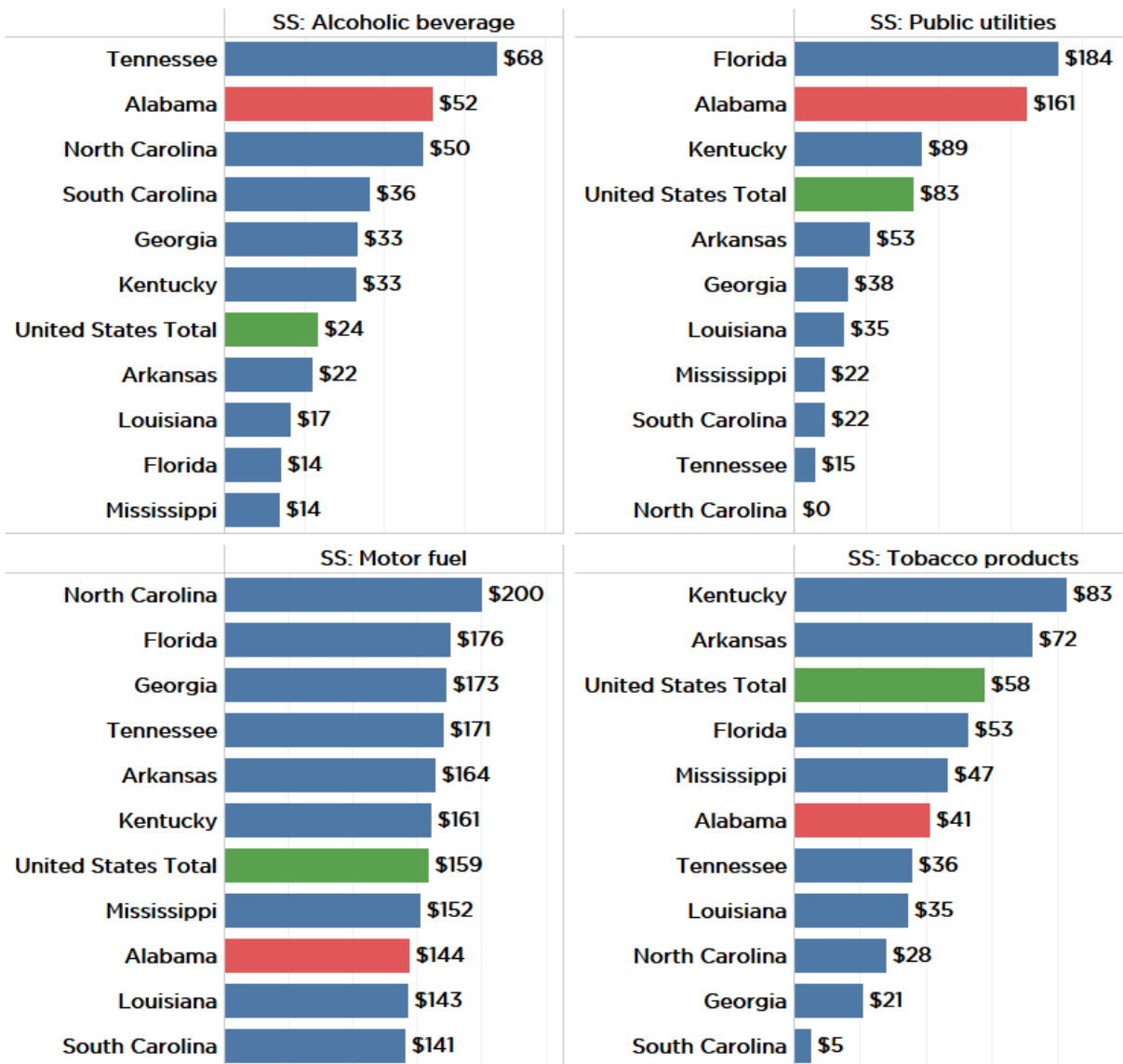
In 2015, Alabama created the Simplified Sellers Use Tax, which captures some of the sales tax revenue from online sales. Further changes to that law were made in 2018, and in June 2018, the U.S. Supreme Court issued a ruling that bolstered states' abilities to tax online sales. Since then, taxes on online sales have continued to climb, with \$185 million collected in FY2020 and \$257 million in FY2021. This tax source was particularly important during the pandemic, as consumers increasingly turned to online shopping and delivery.

<sup>9</sup> Alt, R. (2017, August. Updated Jan. 2018). Sales Taxation of Services, Retrieved Oct. 30, 2020, from <https://www.taxadmin.org/sales-taxation-of-services>.

## Selective Sales Taxes

Alabama governments sometimes turn to selective sales taxes to avoid passing a general tax increase. For example, Alabama ranks high in per capita collections of taxes on alcoholic beverages (No. 3 in the U.S.) and public utilities (No. 4 in the U.S.).

Figure 15. Per Capita Selective Sales Collections in the Southeast, 2019. Source: U.S. Census Bureau, PARCA Calculations.



In 2019, Alabama ranked No. 32 in per capita state and local tax collections on motor fuel, falling in the rankings as tax rate increases in other states increased collection. In 2019, the Legislature raised motor fuel taxes, following the lead of most other



Southeastern states. The increased gas tax revenues will be reflected in future surveys.

Even after the tax increase, Alabama's per-gallon tax rates remain below the national average, as does Alabama's current price per gallon.<sup>19</sup>

In 2019, per capita revenue on tobacco products ranked No. 37 in the U.S. Alabama's state-level tax rate on cigarettes remains relatively low, at 67.5 cents a pack, ranking No. 41 among U.S. states. According to the Campaign for Tobacco-Free Kids, the median tax rate among states is \$1.91 per pack.<sup>20</sup>

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<sup>19</sup> "State Motor Fuel Taxes July-2021," American Petroleum Institute, accessed December 9, 2021, <https://www.api.org/-/media/Files/Statistics/State-Motor-Fuel-Taxes-Charts-july-2021.pdf?la=en&hash=55BE585BEAB89E19ECF7CAE7DC550A5F501B0747>.

<sup>20</sup> "STATE CIGARETTE EXCISE TAX RATES," Campaign for Tobacco Free Kids, accessed December 9, 2021, <https://www.tobaccofreekids.org/assets/factsheets/0097.pdf>.

## Alabama Spending Compared

In the same survey of state and local tax revenues, the Census Bureau also collects data on the amounts spent by state and local governments. Each state divides responsibilities differently between state and local governments. Because of that, this analysis considers both state and local spending together. And as with the comparison of tax revenues, overall spending is divided by the state's population to arrive at a per capita calculation.

These expenditure figures include other non-tax state revenues, like fees, fines, charges, and lottery proceeds. They also include money that the federal government provides to state and local governments.

Some spending categories include federally funded assistance and subsidies based on the number of people in poverty in the state or in enrolled in a school. Since Alabama has higher poverty rates, federal support helps benefit Alabama's spending in those categories.

Similarly, public spending on hospitals and higher education is mainly supported through non-tax revenue. Hospital and higher education revenue primarily come from charges to students and patients, from federal support, donors, and investments, not from state or local taxes.

Aside from the categories mentioned above, Alabama's state and local spending is in the bottom tier of states.

For example, despite having one of the highest incarceration rates in the country, Alabama spends less per capita on its judicial and legal system and its correction system than most

Table 2. Alabama's Rank in State and Local Per Capita Expenditures, 2019

Expenditure Category	50 State Rank
Sewerage	48
Judicial and legal	47
Libraries	46
Transit	45
Air transportation (airports)	45
Corrections	44
Elementary & Secondary education	43
Unemployment compensation	42
Natural resources regulation	41
Fire protection	41
Public welfare	38
Police protection	38
Parks and recreation	37
Health	37
Housing and community development	36
Solid waste management	35
Protective inspection and regulation	33
Insurance benefits and repayments	33
Highways	31
Veterans' services	25
Water supply	24
Assistance and subsidies	15
Higher education	12
Hospitals	6

states.

Alabama provides no state funding for public transit, leaving communities reliant on local and federal funds alone. Spending on K-12 education also lags other states, particularly in the amount of revenue generated at the local level, thanks primarily to property tax restrictions.

## **How Alabama Manages Its Money**

The state has made progress in managing its spending. Historically, Alabama's tax structure has produced a roller-coaster effect: high revenues during periods of growth and sharp contractions during downturns. Better budgeting and saving policies have protected against that historical volatility in recent years.

Also, in the past, faster-growing taxes were fed into the Education Trust Fund, while the General Fund, which pays for non-education agencies, subsisted on taxes that were slow to grow.

That artificial constriction of revenue in the General Fund is related to Alabama's habit of earmarking taxes by law for particular purposes. That gives the Legislature little discretion to move money as needs change. Consequently, the General Fund was frequently in crisis, with no cash available to pay for growing expenses like Medicaid and prisons.

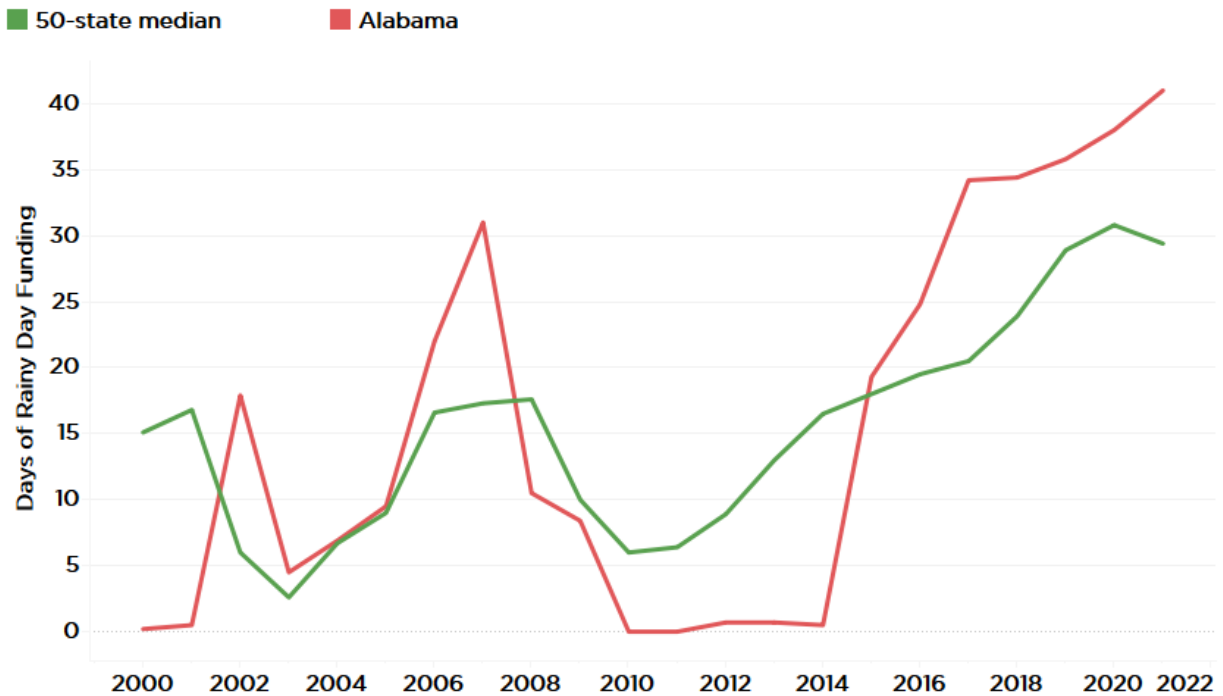
Recognizing the problem, legislators have shifted some growing tax sources into the General Fund. That includes sending most of the tax on online sales, the Simplified Sellers Use Tax, to the General Fund. The result of that change and others like it has been that the General Fund and Education Trust Fund have grown at roughly the same rate for the past several years.

Also, another legislative innovation, the 2011 Rolling Reserve Act, has restrained overspending during flush years while at the same time strengthening state reserves that are available to tap if the economy falters.

Alabama's Rainy Day Funds now contain enough money to cover government operations for 41 days—that's well over the previous peak of 31 days, a level reached before the Great Recession. Those Rainy Day Funds were completely drained during the Recession but almost have been fully repaid, with over \$1 billion now available in case of a downturn. The national median for Rainy Day funds is 29 days. Alabama's

current total is the 16<sup>th</sup> highest in the U.S.<sup>21</sup>

Figure 16. Number of Days the Government could operate on Rainy Day Funds. Source: Pew Charitable Trusts.



<sup>21</sup> "Fiscal 50: State Trends and Analysis," accessed December 3, 2021, <http://pew.org/1Etrxxk>.

## Conclusion

Though state finances were slow to recover from the Great Recession, Alabama's leadership has made changes to the tax system that have increased stability, transferred some growth taxes to the General Fund, and rebuilt depleted state reserve funds.

Economic growth in Alabama has allowed Alabama's tax system to become more productive. More revenue is generated by an expanding number of people in the workforce earning better wages.

However, we still collect less in state and local taxes per capita than any state besides Tennessee.

Though comparative figures are not yet available, all states likely experienced a surge in tax collections in FY2021 due to federal relief and stimulus. Since Alabama depends disproportionately on sales tax to fund state and local government, Alabama governments are seeing larger-than-normal surges in revenue.

It is important to remember that the current situation is unusual and temporary. It is an opportunity to make investments aimed at remedying chronic deficits. Any adjustments made to the tax system should address the inequities, adequacies, and inefficiencies in the current tax system.

There will be calls to cut taxes. However, it's important to remember the current circumstances are highly unusual. Alabama's tax system tends to produce a boom-and-bust cycle. Current levels of growth are unlikely to continue. A contraction is inevitable. Beyond that, with 30 years of underinvestment compared to other states, significant needs must be addressed.

If changes are made, the shortcomings of Alabama's current tax system should be understood, and improvements should address problems of equity, adequacy, and balance.



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